WHAT IS A "PLAN" UNDER INTERNAL REVENUE CODE SECTION 105(D)?

I. Introduction

People generally dislike paying taxes, but we nevertheless recognize that taxes are necessary. One authority observes that our tax laws "reflect a continuing struggle among contending interests for the privilege of paying the least."[1] The most obvious struggle, of course, is over the income tax. The Internal Revenue Service, however, strives to maintain an equilibrium of employing countervailing policies: one which strives for collection of the largest possible amount of money with the least possible amount of administrative expense; others which are designed to protect individuals from undue tax burdens. This latter policy is manifested in part by allowing an exclusion from gross income for "sick pay."

II. Ideological Foundation of the Sick Pay Exclusion

Two idealogical concepts merit consideration in connection with the "sick pay" exclusion. The first is the ability of the taxpayer to meet tax burdens. The slogan, "ability to pay," suggests it is consistent with federal income tax policy that tax burdens should be shared according to the abilities of the taxpayers.[2] This concept compels a measurement of the potentialities of individuals which could never be measured precisely. Nevertheless, ability to pay has been measured by the net income of the individual. This is undoubtedly the method and perhaps the only practical method of measurement. From the point of view of the federal government, there would seem to be small advantage in taxing subsistence incomes because such would result in further impoverishment of the impoverished which in turn would lead to increased demands upon the federal government for welfare expenditures.[3] The second ideological concept is the matter of equity; *i.e.*, the idea that taxpayers similarly situated should be similarly treated. This notion, of course, implies that special relief should be given to certain taxpayers who are differently situated from all other taxpayers.[4]

There can be little doubt that when the exclusion for "sick pay" was conceived, legislators were distressed about undue financial burdens carried by persons who were sick or physically disabled. That

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[1] L. Eisenstein, The Ideologies of Taxation 3, 4 (1961).

[2] *See generally* Buehler, "Ability to Pay" 1 Tax L. Rev. 243 (1946).

[3] *Id.* at 252.

[4] Eisenstein, "Some Second Thoughts on Tax Ideologies" N.Y.U. 23rd Inst. on Fed. Tax. 1, 3 (1965).

persons absent from work due to illness have a decreased ability to pay is most obvious in cases where the employee loses his pay and incurs medical debts. No undue tax burden allocable to the period of illness exists in this situation since ability to pay is measured by net income. However, where a person receives "sick pay" during the course of his absence from work, his apparent ability to pay, as measured by the tax tables, is not substantially decreased. Yet he is left with his tax burden plus his medical debts.[5] Without an exclusion for "sick pay," the person so misfortunate as to be absent from work because of illness is placed in the same class with taxpayers who have no similar predicament. Thus, it seems that any criticisms or suggested revisions of the "sick pay" exclusion legislation should be directed at taking the greatest account possible of the ability to pay so as to treat, within the limitations of practicality, each taxpayer equitably.

III. The 1939 Code Provision

The "sick pay" exclusion is of comparatively recent origin. The policy of allowing exclusions from gross income for "sick pay" was first effectuated in section 22(b)(5) of the Internal Revenue Code of 1939. That section provided that compensation for injuries or sickness were excludable if received through accident or health insurance or under workmen's compensation acts.[6] Although the words "accident or health insurance" have a traditional meaning which is clear, they were to become the focal point of the litigation involving that Code section. The lack of specific definition in either the Code or the Regulations generated much uncertainty.

The first case reaching beyond the traditional meaning of "health and accident insurance" was *Epmeier v. United States*.[7] In that case, an insurance company employee had brought action to recover income

[5] There is, of course, some tax relief granted in the form of a deduction for medical expenses under Int. Rev. Code of 1954, § 213.

[6] Int. Rev. Code of 1939, § 22(b)(5) provides as follows:

> (b) Exclusions from Gross Income.—The following shall not be included in gross income and shall be exempt from taxation under this chapter:
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> (5) Compensation for injuries or sickness.—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 23(x) in any prior taxable year, amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness, and amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country.

[7] 199 F.2d 508 (7th Cir. 1952).

taxes paid on 1,800 dollars in sickness benefits. The plaintiff's employer had in effect for its employees a self-insured life and health plan which was available to all employees who were able to qualify by passing a medical examination. The issue was whether or not the benefits paid were amounts received through health insurance under section 22(b)(5) of the 1939 Code, and it was held that they were. The court took note of the fact that the plan under which the payments were made was somewhat different in form from the insurance contracts sold commercially, although some characteristics of a formal insurance contract were present.[8] Commenting that it knew of no reason why insurances must be expressed in a formal policy, the court held that the statutory provision was intended to give relief to a taxpayer who had the misfortunes of becoming ill or injured and of incurring extra financial burdens. Allowing the exemption, the court added "[s]urely there is no legal magic in form; the essence of the arrangement must determine its legal character."[9]

That *Epmeier* represented an expansion of previous administrative policy is clearly demonstrated by the Commissioner's refusal to accept this decision.[10] The process of expanding the definition of health and accident insurance to effectuate more equitable treatment of taxpayers thus reached a standstill requiring either an action of the Supreme Court or a revision by the legislature; eventually both occurred.

The final word with respect to the definition of health and accident insurance under the 1939 Code was handed down by the United States Supreme Court in *Haynes v. United States*.[11] In this case the plaintiff, an employee of a telephone company, received payments of 2,100 dollars under a company disability benefit plan during the year 1949. The Internal Revenue Service collected 318 dollars income tax on those benefits. Plaintiff brought an action for a refund claiming an exemption under the statute. The district court found that the payments were not taxable and ordered a refund. The court of appeals reversed holding "that Southern Bell's plan was not 'health insurance' but a 'wage continuation plan'."[12]

The Supreme Court, however, in an opinion delivered by Mr. Justice Black, defined health insurance broadly as "an undertaking by one person for reasons satisfactory to him to indemnify another for

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[8] A medical examination is a common insurance contract requirement, as is the distinction maintained between employees passing and failing their medical examinations.

[9] Epmeier v. United States, 199 F.2d 508, 511 (7th Cir. 1952).

[10] Rev. Rul. 208, 1953-2 Cum. Bull. 102.

[11] 353 U.S. 81 (1957).

[12] *Id.* at 83.

losses caused by illness."[13] The court, believing that the plan in question was encompassed by that definition, observed that the plaintiff had received the same kind of protection under the plan in question as he would have received from a commercial insurance policy. The primary significance of this decision is not in holding that health insurance must be defined broadly but in its reaffirmance of the principle that form must be relegated to a position secondary to substance. This case also serves as a reminder of the possibility that the application of a statute may become illogical if the underlying purpose of the legislation is disregarded.

Long before the Supreme Court rendered its decision in *Haynes*, Congress was already probing for revision, many congressmen having realized the inequities of distinguishing between formal insurance plans and individual self-insured plans. Employees who were receiving the same benefits under two similar programs were being treated differently by the statute.

IV. The 1954 Code Provision

Unfortunately the legislative history of section 105(d) of the Internal Revenue Code of 1954 is quite sparse in its reference to the definition of "wage continuation plans." The original bill H.R. 8300, as first approved by the House of Representatives, did not contain a provision covering "wage continuation plans." Instead, that body, realizing that controversy had been generated by *Epmeier*, intended by the new bill to provide a rule of exclusion applicable to amounts received by the employee under a plan as compensation for personal injuries or sickness whether or not the plan was funded through insurance.[14] Subsection (b) of the original section 105 limited exclusion to payments at a rate not exceeding 100 dollars per week less the weekly rate of any nonqualified compensation for the same period.[15] Nonqualified compensation was defined as payments which did not meet the criteria of subsection (c), which generally stated that a plan must be for the exclusive benefit of employees and must be nondiscriminatory (*i.e.*, of a type which would qualify for exemption as a pension plan under section 501(e) of the 1954 Code.)[16] Thus, under a partnership form of enterprise, a plan which covered the partners as well as the employees would not qualify.

Further requirements were that "[a]ll of the employees covered by

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[13] *Id.*

[14] H.R. Rep. No. 1337, 83d Cong., 2d Sess. A33 (1954).

[15] *Id.*

[16] *Id.*

the plan must have an enforceable right to the compensation covered under the plan during the period when the plan remains in effect,"[17] and "a plan which provides for payment of compensation for loss of wages during a period of sickness must provide a waiting period prior to the time when benefits may be received under this section."[18] Of particular interest is the fact that the waiting period requirement applied only to compensation for lost wages. Where compensation related to loss due to medical or hospital expenses, the exclusion became applicable immediately. Noting that the exemption of compensation for loss of wages applies only to wages lost because of absence from work due to sickness or personal injury, it is unclear why a distinction was made between compensation for wages lost and compensation for loss due to medical or hospital expenses.

The phrase "wage continuation plan" was perhaps first given legislative recognition in a proposed amendment to H. R. 8300 submitted by Senator Morse of Oregon.[19] The announced purpose of this proposal was to reduce restriction inherent in the qualified plan criteria.[20] Commenting on the 100 dollars per week limitation, Senator Morse concluded that this was a wise limitation in that it would keep possible abuses by corporate executives to a minimum, but the Senator heartily objected to the waiting period limitation.[21] Aware that most health and accident plans include a waiting period, and without commenting on the merits of waiting periods, the Senator asserted that it was not the function of Congress to legislate on the matter of how long

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17 *Id.*

18 *Id.* at A34.

19 100 Cong. Rec. 9322 (1954). The proposed language is as follows:

> (d) Wage continuation plans: Gross income does not include amounts referred to in subsection (a) if such amounts constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injuries or sickness; but this subsection shall not apply to the extent that such amounts exceed a weekly rate of $100. If such amounts are not paid on the basis of a weekly pay period, the Secretary or his delegate shall by regulations prescribe the method of determining the weekly rate at which such amounts are paid.

20 *Id.* at 9322 to 9323.

21 *Id.* at 9323. Senator Morse stated:

> A limitation of $100 per week has been placed on amounts excluded from gross income when received as compensation for loss of wages under a so-called disability plan. In my judgment this is a wise limitation, because it is my understanding that in the past corporation executives and other high-salaried employees have been able to draw the amounts of their regular salaries as tax-exempt "disability" benefits from special plans while on extended vacations taken on "doctor's orders."

an employee must be off work in order to receive disability benefits.[22] Furthermore, he thought that the waiting period limitation in the statute would stimulate the use of a waiting period provision in health and accident plans.[23] Senator Morse's persuasive arguments against a waiting period were apparently rejected in the Senate's version of the bill. That version did, however, include a similar subsection (d). It provided that amounts described in subsection (a) should not be included in gross income if the amounts constituted wages or payments in lieu of wages for a period which an employee was absent from work because of personal injuries or sickness.[24] There were two limitations upon the exemption. The first limitation provided a ceiling of 100 dollars on the exemption. The second provided a seven-day waiting period during which payments were not exempt.[25] The waiting period provided in the Senate version was applicable whether payments were attributable to lost wages or medical or hospital expenses. Thus, the House version's illogical distinction between the two types of payments was removed. Moreover, the Senate version specified a particular waiting period while the House version left the length of the waiting period to the discretion of the Commissioner.

The Joint Conference Committee substantially adopted the Senate version of the bill.[26] Subsection (d) as it appeared in the conference version provided that gross income did not include amounts specified in subsection (a) if the amounts were for wages or payments in lieu of wages for a period during which the worker was off work on account of personal injuries or sickness.[27] The 100 dollars per week limitation was also adopted. The seven-day waiting period was included and made applicable when the absence from work was due to sickness. The most noticeable change from the Senate version was that applicability of the seven-day waiting period now depended upon whether the absence from work was due to sickness or personal injury rather than whether the payments were for wages lost or for medical or hospital expenses.

The statutory language in effect today is little changed from that which was adopted in the conference version. Section 105(a) of the Internal Revenue Code of 1954 provides generally that amounts received through accident or health insurance for losses due to sickness or personal injuries shall be includible in gross income when the amounts are attributable to contributions made by the employer which were not

22 *Id.*
23 *Id.*
24 S. Rep. No. 1622, 83d Cong., 2d Sess. 184 (1954).
25 *Id.*
26 H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 5 (1953).
27 *Id.*

taxable as gross income of the employee.[28] That section also deems includible direct payments by the employer to the employee for losses due to sickness or personal injury.[29] Section 105(d) operates as an exception to section 105(a) and is essentially the same today as the joint conference version, but the provisions of section 105(d) do not now apply to amounts attributable to the first thirty days of the absence period if the amounts exceed seventy-five percent of the employee's regular wages.[30] If the payments attributable to the first thirty days are not more than seventy-five percent of the employee's wages, this section will not apply to the extent that the amounts received exceed a rate of 75 dollars per week.[31] Furthermore, the seven-day waiting period does not apply if the employee is hospitalized for at least one day during the period regardless of whether hospitalization was due to personal injury or sickness.[32]

V. Focal Point of Litigation

Because of the legislative history of section 105 of the 1954 Code, the statutory wording of that section, and the recent litigation involving

[28] Int. Rev. Code of 1954, § 105(a) provides as follows:

> Amounts Attributable to Employer Contributions.—Except as otherwise provided in this section, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

[29] *Id.*

[30] Int. Rev. Code of 1954, § 105(d) provides as follows:

> Wage Continuation Plans.—Gross income does not include amounts referred to in subsection (a) if such amounts constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injuries or sickness; but this subsection shall not apply to the extent that such amounts exceed a weekly rate of $100. The preceding sentence shall not apply to amounts attributable to the first 30 calendar days in such period, if such amounts are at a rate which exceeds 75 percent of the regular weekly rate of wages of the employee (as determined under regulations prescribed by the Secretary or his delegate). If amounts attributable to the first 30 calendar days in such period are at a rate which does not exceed 75 percent of the regular weekly rate of wages of the employee, the first sentence of this subsection (1) shall not apply to the extent that such amounts exceed a weekly rate of $75, and (2) shall not apply to amounts attributable to the first 7 calendar days in such period unless the employee is hospitalized on account of personal injuries or sickness for at least one day during such period. If such amounts are not paid on the basis of a weekly pay period, the Secretary or his delegate shall by regulations prescribe the method of determining the weekly rate at which such amounts are paid.

[31] *Id.*

[32] *Id.*

section 105(d), it appears that the definition of "wage continuation plan" will be the focal point of litigation in years to come. While it is true that no statutory definition of "wage continuation plan" was provided, the Regulations draw some rather general guidelines which approach a definition. Treasury Regulation section 1.105-4(2)(i) (1964) states that a "wage continuation plan" means an accident or health plan as defined in Treasury Regulation section 1.105-5. The latter section defines an accident or health plan as an arrangement for payment to employees in case of sickness or personal injury.[33] A plan may cover only one employee or it may cover more, and plans may be different for different employees or for different classes of employees.[34] Thus, the language seems to eliminate any requirement for nondiscrimination, a matter which the House of Representatives was so concerned with when the bill was first drafted. A plan may be funded or not and insured or not; it neither need be in writing nor enforceable by the employee.[35] If, however, the employee cannot enforce his rights, an arrangement will constitute a plan only if the employee was covered at the time of sickness or injury and the employee had either been given notice of the arrangement prior to the time of sickness or such knowledge was reasonably available to him.[36]

The rulings of the Commissioner have been only somewhat helpful in elucidating the general guidelines set forth in the Regulations. In a 1960 ruling, a bonus plan which was silent as to any relationship between it and absence from work on account of sickness or injury was held not to be a "wage continuation plan" within the meaning of section

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[33] Treas. Reg. § 1.105-5 (a) (1964) states in part as follows:

> In general, an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. A plan may cover one or more employees, and there may be different plans for different employees or classes of employees. An accident or health plan may be either insured or noninsured, and it is not necessary that the plan be in writing or that the employee's rights to benefits under the plan be enforceable. However, if the employee's rights are not enforceable, an amount will be deemed to be received under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan (or a program, policy, or custom having the effect of a plan) providing for the payment of amounts to the employee in the event of personal injuries or sickness, and notice or knowledge of such plan was reasonably available to the employee. It is immaterial who makes payment of the benefits provided by the plan. For example, payment may be made by the employer, a welfare fund, a State sickness or disability benefits fund, an association of employers or employees, or by an insurance company.

[34] *Id.*

[35] *Id.*

[36] *Id.*

105(d).[37] With respect to the matter of definition, it was stated that: "Implicit in these provisions is the requirement that there exist some positive correlation, or causal connection, between the absence due to injury or sickness and the payment made to the employee. Such payment must be on account of such absence."[38] In an earlier ruling the Service held that the term "wage continuation plan" included plans which grant continued benefits to the employee until either he is able to return to work or reaches retirement age.[39] This ruling further held that the exclusion from gross income is not destroyed by the fact that the disabled employee engages in some part-time work for himself or for another employer apart from his regular employment during the period of disability.[40] One additional ruling has substantiated the fact that the absence of a formal plan is not always fatal to a claimed exemption.[41] In that case the worker was employed by the state legislature. Although legislative employees were not covered by the state employee plan, disability benefits were granted to legislative employees as a matter of custom and tradition.[42]

Jackson v. United States,[43] one of the first instances where the "wage continuation plan" issue was litigated, indicated a leaning by the court toward a liberal construction of the term. In that case, the plaintiff's decedent was a founder, executive vice president, and director of a certain financial institution. Unable to work after the latter part of 1953 due to illness, plaintiff's decedent resigned as a director in 1954 but remained executive vice president until his death. Ineligible for the institution's regular pension plan because of his age, plaintiff's decedent and the president of the institution agreed that the decedent would receive 4,800 dollars per year for the period of his absence from work. Use of the word "pension" was not fatal to a claimed exemption under section 105(d). The district court was of the opinion that congressional enactments intended to relieve the tax burdens of sick or injured employees should be liberally construed.[44]

Factually similar to *Jackson*, and perhaps the most cited case concerning "wage continuation plans" is *Estate of Kaufman*.[45] There plaintiff's decedent organized a loan association and acted as its manag-

37 Rev. Rul. 60-203, 1960-1 Cum. Bull. 41.

38 *Id.*

39 Rev. Rul. 57-178, 1957-1 Cum. Bull. 71.

40 *Id.*

41 Rev. Rul. 59-265, 1959-2 Cum. Bull. 42.

42 *Id.* at 43.

43 3 Am. Fed. Tax R. 2d 517, 59-1 U.S. Tax Cas. ¶ 9171 (D. Wisc. 1958).

44 *Id.*

45 35 T.C. 663 (1961), *aff'd*, 300 F.2d 128 (6th Cir. 1962).

ing officer until mid-1953. In June of 1953, the decedent suffered a stroke and was able to return to his office only once between June and the time of his death in 1958. The decedent continued to hold the offices of executive vice president and treasurer of the association, to which he was elected after his stroke, until his death. The decedent continued to receive his full salary until his death and he was visited occasionally by members of the association to discuss affairs of the association. In only one other instance had the association retained a disabled employee on the payroll. In 1955 the loan association began a retirement pay plan for all its employees. The decedent claimed a 5,200 dollars sick pay exclusion in his 1955 tax return which was disallowed. The Commissioner claimed that the plaintiff failed to prove that payments were received according to the terms of a health or accident plan. The court considered that the legislative use of the word "plan" required something more than "merely one or more *ad hoc* benefit payments."[46] The court, further observing that the decedent was consulted after his stroke and continued as a member of the board of directors, concluded that the payments were compensation for the decedent's services.

The court in *Kaufman* did not attempt to evaluate the reasonable value of decedent's services after the stroke, but it would seem that the stroke would decrease the amount and value of service which decedent could perform. This possibility suggests that the amount of the decedent's receipts over and above the reasonable value of his services did in fact constitute a compensation for loss of wages or payment in lieu of wages due to absences from work caused by sickness or personal injury. Stated differently, it seems that a partial exemption should be allowed in case of a partial disability rather than "all or none." Perhaps this possible weakness could be corrected by amending section 105(d) to provide for a partial exemption. If the Service would permit partial exclusion for partial disability, the plan could provide the mechanism without further burden upon the Service. The employee could designate the percentage of the payment which represents compensation and the percentage which represents "sick pay." Furthermore, it seems that the court's distinction between compensation for services performed and compensation for loss of wages or payments in lieu of wages due to absence from work is highly artificial. Actually, all transfers by an employer to an employee whatever the form of payment are compensation for service performed.

However, the *Kaufman* case was decided properly but not because of a distinction between compensation for service performed and payments for lost wages.

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[46] *Id.* at 666.

Speaking of the word "plan" in the nonlegal sense, there was certainly a design to continue payments to Kaufman after his stroke, and this design amounted to a great deal more than a series of *ad hoc* payments, if that phrase signifies that the question of payment or nonpayment was reconsidered each time a payment was made. It is doubtful, however, that the board of directors ever contemplated payments to Kaufman before the date of stroke since it had only been done once in the past. In addition, Kaufman had no knowledge of a "plan" nor was knowledge of such a plan reasonably available to him. Without one of these two requirements, the policy of allowing tax exemption in cases of "wage continuation plans" would be subject to endless abuse; and because the plaintiffs in *Kaufman* did not meet either of these requirements, the exemption was properly denied.

Shortly after the *Kaufman* decision, an Ohio district court in *Andress v. United States*[47] reached a result which may on the surface appear conflicting. In that case plaintiff's decedent was employed as the president of a department store corporation. Before 1945, he received both a salary and a share of the profits, for he shared authority in the policy-making of the corporation. After 1945, the decedent was returned to a straight salary since he no longer shared in the policy-making. A few years later the decedent was named to an honorary office, and it was agreed that he should receive 15,000 dollars per year for the remainder of his life whether or not he worked and whether or not he was able to work. The decedent continued to receive the agreed salary until his death although he was unable to work part of the time between the agreement and his death. Plaintiff claimed that the decedent was entitled to an exemption under section 105(d) because he was paid under a prior agreement which was a wage continuation plan, 100 dollars per week was excludible. The defendant, relying on *Kaufman*, claimed that the salary payments were *ad hoc* payments insufficient to constitute a plan. The court allowed the exemption reaffirming the fact that a plan need apply to only one employee and the liberality of the courts in construing congressional enactments intended to relieve the tax burden of sick or injured employees.[48]

In both *Kaufman* and *Andress* the taxpayers continued to receive their salaries during periods of absence from work due to sickness or personal injury. But there are two major differences in the factual situations which justify the respective courts in reaching opposite conclusions. First, in the *Kaufman* case, the taxpayer was able to render at least some useful services to his employer during the period of his

[47] 198 F. Supp. 371 (N.D. Ohio 1961).

[48] *Id.* at 376.

illness. On the other hand, in *Andress*, the taxpayer was totally disabled and therefore incapable of performing any useful service for his employer after the onset of his illness. Therefore, there could be no claim that the payments to Andress constituted compensation for services performed. Secondly, in *Kaufman,* the taxpayer had made no arrangement with his employer prior to the illness regarding compensation in case of disability. In fact the board of directors decided to continue Kaufman's salary after he had suffered the stroke, and the "plan" under which decedent's heirs had claimed an exemption did not come into existence until nearly two years after the occurrence of the stroke. In contrast, Andress had reached an agreement with his employers prior to the beginning of his illness which provided for continuation of salary for life regardless of whether the decedent worked or not and regardless of whether the decedent was able to work or not. Therefore, to apply the general criteria of Treasury Regulation Section 1.105-5, which specifies that the employee's rights must be enforceable or knowledge of the "plan" must have been reasonably available to the employee at the time of the illness or injury, the factual situation in *Andress* apparently qualifies under both these prerequisites. The agreement between Andress and his employers may well have been enforceable had the employers stopped the payments, and it is certain that Andress had knowledge of the existence of a plan prior to the beginning of his period of illness.

More recently, two additional cases have been decided in which the result turned upon whether or not the taxpayer had enforceable rights or had knowledge of the plan at the time of the illness or injury. In *Lang*,[49] the taxpayer's employer had in effect a general policy whereby salaried employees received payments during periods of absence due to illness or injury and hourly employees did not. In no case were there any enforceable rights and the final decision with respect to any particular employee always rested with the managing office. The plaintiff-taxpayer in this case was a sales manager on salary and became unable to work because of heart attack. The managing officers had decided not to continue his compensation payments, but he successfully prevailed upon them to reconsider. The court concluded that there was no plan under section 105(d) because plaintiff had no enforceable right to continued compensation, nor was knowledge of the plan reasonably available to him. The court recognized the right of the employer to treat various classes of employees differently but stated that the rules must be determinable before the employee's sickness arises.[50]

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[49] 41 T.C. 352 (1963).

[50] *Id.* at 355-56.

In *Estate of Chism v. Commissioner*[51] the Court of Appeals of the Ninth Circuit reached the same result as the Tax Court did in *Lang*. The plaintiff-taxpayer and his family held all the shares of an ice cream business. Plaintiff, who acted as president of the company, was disabled from work due to an illness. Relying on section 105(d), he claimed an exemption, which was denied by the Commissioner. The court of appeals, in affirming the action of the Commissioner, noted that the "plan" under which plaintiff had claimed exemption had never been reduced to writing, the employees were never formally notified of the existence of a "plan," and the rights of the employees were subject to change without their consent.[52] Perhaps worthy of mention is the ninth circuit's apparent requirement of a formal notification where the rights of the employees are not enforceable. This requirement is somewhat more stringent than the notice specified in Treasury Regulation section 1.105–5, which merely requires that knowledge of the "plan" be reasonably available to the employee. An informal notice will suffice. The difference, however, may only be that between a printed circular and oral notice by a personnel employee.

With respect to the purpose of payments to a disabled employee, the *Kaufman* court concluded that since the taxpayer's services in an advisory capacity were useful to the employer-association, payments were compensation for services performed rather than compensation for lost wages. However, one recent case disregarded occasional services by an employee to hold that a "wage continuation plan" did exist.[53] In that case plaintiff, who was a vice president and member of the board of directors, was unable to work because of a nerve disease. The court found that although plaintiff returned to the office occasionally, he did not do any useful work. The court failed to discuss plaintiff's value in an advisory capacity. Perhaps there is some ground for argument that at least some portion of plaintiff's payments were for services performed.

Though much of the general criteria for a "wage continuation plan" is not clear, one factual characteristic is fairly clear though its determination may be difficult. Where payments are made to a taxpayer who is past the retirement age, section 105(d) is totally inapplicable.[54] In determining whether a given employee is beyond the retirement age or not, the employing company's policy must be considered.[55] This consideration may require a large volume of statistical

[51] 322 F.2d 956 (9th Cir. 1963).

[52] *Id.* at 961.

[53] Niekamp v. United States, 240 F. Supp. 195 (E.D. Mo. 1965).

[54] Treas. Reg. § 1.105-4(a)(3)(1)(a) (1966).

[55] Commissioner v. Winter, 303 F.2d 150 (3d Cir. 1962).

evidence and analysis which is both costly to the plaintiff and time-consuming for the courts. Perhaps the Commissioner should specify some age limit, such as sixty-five, as a guide for application of section 105(d). Admittedly an inflexible age limit might operate arbitrarily in some cases, but since age sixty-five is the usual retirement age and since persons over sixty-five are given other tax advantages such as an extra personal deduction,[56] possible injustices would seem to be minimal. The advantages which would obtain from such a regulation would be a decrease in litigation; where litigation is necessary, there would be a saving of time and expense in presentation of evidence. The advantage of such a regulation would seem to overshadow the disadvantages of an arbitrary age limit.

In some litigation regarding the retirement issue, the courts have accepted written plans as complying with the requisites of section 105(d) without discussion.[57] It may be useful to examine the characteristics of those plans.

The "wage continuation plan" which was accepted without question in *Corkum v. United States* provided for two retirement plans; one was for disability and the other for old age. The first plan was applicable when an employee became totally and permanently incapacitated before attaining a certain age, provided he had completed a certain term of service with the company.[58] Since this plan was applied

[56] Int. Rev. Code of 1954, § 151(c).

[57] Bigley v. United States, 252 F. Supp. 757 (E.D. Mo. 1966); Corkum v. United States, 204 F. Supp. 471 (D. Mass. 1962).

[58] The "plan" in Corkum v. United States, 204 F. Supp. 471 (D. Mass. 1962), is recited as follows:

> Conditions for Allowance. Any member in service classified in either Group A or Group B who becomes totally and permanently incapacitated for further duty before attaining age fifty-five and after completing fifteen or more years of creditable service, or any such member who is a veteran as defined in section one who becomes totally and permanently incapacitated for and after completing ten or more years of creditable service, upon his written application on a prescribed form filed with the board or upon such an application by head of his department after a hearing, if requested, as provided for in subdivision (1) of section sixteen and subject to the conditions set forth in said section and in this section, shall be retired for ordinary disability as of a date which shall be specified in such application and which shall be not less than fifteen days nor more than four months after the filing of such application but in no event later than the maximum age for his group, nor earlier than the last day for which he received regular compensation. No such retirement shall be allowed unless the board, after such proof as it may require, including in any event an examination by the medical panel provided for in subdivision (3) of this section and including a certification of such incapacity by a majority of the physicians on such medical panel, shall find that such member is mentally or physically incapacitated for further duty, that such incapacity is likely to be permanent, and that he should be so retired. *Id.* at 472 n.1.

according to the judgment of a specially appointed board, enforcement of rights by an employee would be difficult although perhaps technically possible. The plan apparently did not provide payments for persons temporarily incapacited. From this case it might be concluded that section 105(d) is applicable even when there is no possibility that the employee could ever return to work, subject to the condition, that the employee is below the retirement age. In *Bigley v. United States*,[59] a similar plan was considered without question as complying with the requisites of section 105(d). That plan provided a disability pension for employees disabled because of sickness or injury if those employees could ordinarily qualify for a service pension. The pension was to be continued as long as that particular employee was unable to return to the service of the company.[60] Returning employees were able to retain seniority as the period of disability was treated as a leave of absence.[61] This case may indicate that the employer's criteria for applicability of a "plan" may be similar to its retirement pension ar-

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[59] 252 F. Supp. 757 (E.D. Mo. 1966).

[60] *Id.* at 472. The plan was set out as follows:

Section 4. Pensions

1) a) All male employees who have reached the age of sixty years and whose term of employment has been twenty or more years and all female employees who have reached the age of fifty-five years and whose term of employment has been twenty or more years shall if they so request, or may at the discretion of the Committee, be retired from active service and, upon such retirement, shall be granted service pensions.

b) Any employee whose term of employment has been thirty years or more, or any male employee who has reached the age of fifty-five and whose term of employment has been twenty-five or more years, or any female employee who has reached the age of fifty years and whose term of employment has been twenty-five or more years may, if the case is approved by the Committee as appropriate for such treatment, be retired from active service and, upon such retirement, shall be granted a service pension.

c) Any employee who has become totally disabled as a result of sickness or of injury, . . . and whose term of employment has been fifteen years or more, shall upon retirement by reason of such disability be granted a pension, which pension is designated a "disability pension"; provided, that if, at the time of such retirement, the employee is qualified for a service pension under subparagraph (a) or (b) above, a service pension shall be granted instead of a disability pension. A disability pension shall continue so long as the employee is prevented by such disability from resuming active service with the Company. If the employee recovers sufficiently to resume active service, the disability pension shall be discontinued and if the employee reenters the service of the Company at that time, the period of absence or disability pension shall be considered as a leave of absence and not as a break in the continuity of the employee's service.

In Keefe v. United States, 247 F. Supp. 589 (N.D.N.Y. 1965), the same plan was accepted by the court without question.

[61] *Id.*

rangement and contained in the same document. The above-mentioned examples are not extremely helpful in that the courts did not discuss their respective applications of the general criteria for a "plan."

VI. PROPOSALS

It is evident from the few cases which have turned upon the "wage continuation plan" issue that the definition of that term is far from clear. Courts deciding this issue have been and will continue to be concerned with what was the intent of Congress, but there must also be some regard for how the taxpayer can be given the fairest treatment. It is possible that Congress did not intend for the term "wage continuation plan" to be a test independent of the usual insurance criteria.[62] If this criteria is what Congress intended, the only difference between a "wage continuation plan" and an "insurance plan" would be whether the employer purchased insurance from an insurance company or financed an arrangement of his own. An adoption of this view would interject more predictability into the Code. However, it is more likely that Congress intended that the term "plan" should be an independent test of qualification.

Consistency with the probability that Congress intended to construct an independent test demands a discarding of the traditional criteria for insurance. There remains an entire gamut of possible combinations of criteria. At one extreme a "plan" could be defined as merely an informal understanding between the employer and his employees that the employer will take care of his employees in case of accident or illness. At the other extreme a "plan" could require specific coverage and benefits formally communicated to the employees covered. One commentator apparently believed that Congress had intended the more liberal criteria to apply, for he speculated that qualifying under the criteria for a plan should present little difficulty.[63] But cases decided since that speculation have indicated that qualification is not so easy. While it is true that a liberal criteria for "wage continuation plan" would provide employers with much more freedom, it would also seem true that there would be much greater opportunities for abuse. For example, an employer might attempt to adopt a plan which would inadequately protect the employees but confer extensive benefits on himself merely to obtain the advantages of section 106, which provides an exemption for employer contributions to

62 Comment, "Taxation of Employee Accident and Health Plans Before and Under the 1954 Code" 64 Yale L.J. 222, 230 (1954).

63 Gornick, "The 1954 Internal Revenue Code: Sick Pay, Meals, Lodging, Salesmen's Expenses" 41 A.B.A.J. 612, 614-15 (1955).

plans. Thus, it seems that there is some need for protecting the employee in this respect.[64]

A more stringent criteria for qualification as a "plan" would restrict policy making of the employer. But the stringent approach seems to have several advantages. First, it would operate to protect the employees by influencing the employers to adopt maximum coverage plans. Secondly, it would have the effect of reducing litigation in this area by making the law a great deal more predictable.

Another ambiguous requirement of section 105(d) is that the "plan" must be a plan for employees. It has been generally conceded without argument that corporate executives are employees within the meaning of section 105(d). But one writer has expressed doubt that partners would be considered employees.[65] Perhaps it should be added that it is doubtful that individual proprietors would be considered employees within the meaning of section 105(d). The question is whether partners and individual proprietors should be treated differently from managing officers of a corporation. The answer must be yes. Though a corporate officer may control the plan under which he benefits, he is not directly chargeable with the cost. Allowing tax relief to either partners or individual proprietors would, in effect, result in a double exemption because those parties are entitled to exclude the cost of such "wage continuation plan." Another question arises with regard to the same ambiguity. Does this requirement that a "plan" must be for employees indicate that the "plan" must cover only employees or would a plan covering both partners and employees qualify as to exclusions claimed by employees? Neither reported cases nor the regulations answer this question, but it would seem that the fact that a "plan" covers nonemployees as well as employees should not operate to deny the exclusion for the employees because the "sick" employee needs tax relief regardless of which type plan covers him.

As was previously mentioned, there is no authority in either the Code, Regulations, or decisions which require that a plan be nondiscriminatory with respect to individuals covered. While there may be justifiable reasons for treating various classes of employees differently, there would seem to be no just reason for treating members of the same class differently. A provision in the original House version of the Code included guarantees against discrimination, but that pro-

64 An employer could devise a plan which allowed himself generous benefits while allowing small benefits to his employees. Perhaps protection for the employees could be accomplished by establishment of criteria for a qualified plan similar to that used for pension plans and profit sharing plans. *See generally* Int. Rev. Code of 1954, § 401.

65 Pyle, "Accident and Sickness Insurance under Code Sections 104, 105, 106 and 213" 34 Taxes 363, 371 (1956).

vision was deleted by the Senate.[66] It is therefore doubtful that a discriminatory plan would for that reason fail to qualify under the criteria for a "wage continuation plan." A tax benefit statute which stands idly in the face of discrimination promotes it in effect. Perhaps there is need for an amendment to section 105(d) and section 106 requiring that a "plan" must cover all members of the classes of employees covered and that it must provide equal benefits for those members.

It has also been suggested that a "plan" should be enforceable by the employee in order to qualify for exemption purposes because if there is no obligation, there can be no plan.[67] But there may be justifiable motives for the employer desiring to avoid enforceable obligations, and requiring enforceability may discourage employers from adopting plans. For example, the employer may wish to preserve for himself an escape valve in case of a decline in the economy or a business reversal. If the employer refused to pay or discontinued payments, the policy or custom would be destroyed thereby disqualifying the arrangement as a "plan." While it is true that the fastest and safest way to establish a qualifying "plan" is to create an enforceable written obligation, there seems to be no good reason to impose this formal requirement so long as in substance the same effect is obtained through application of an unenforceable arrangement.

The arrangement whether enforceable or not should be published, however, and made available to the employees so covered. As the law now stands, there is no requirement for a publication. It seems that such a requirement would not unduly burden employers, and it would operate to further protect the federal government against possible abuses. But it would be unreasonable to require a writing where only handful of employees were involved. An amendment is recommended requiring a publication of "plans" covering four or more employees. The notice requirement would remain the same for "plans" covering less than four employees.

Finally, there remains the matter of whether the above-mentioned goal can be best accomplished by specific statutory language or by general statutory language leaving the particulars to the judiciary. While it may be true that specific legislation occasionally results in inequity, it seems to be the best solution especially from the standpoint of ease of administration.[68] A statute should be highly articulate so as to set forth in detail the deductions and exemptions which will

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[66] *Id.*

[67] *Id.* at 372.

[68] Specificity in tax legislation is apparently the trend. *See* Paul, "Directions in Which Tax Policy and Law Have Been Moving," 30 Taxes 949 (1952).

be allowed. There exists, however, a danger of overcomplication which could result in relaxed administration due to personnel limitations of the Internal Revenue Service. Specific statutory language would hopefully reduce the volume of litigation while general statutory language would probably lead to increased litigation. Furthermore, specific language would tend to minimize differences among the circuits in judicial administration and general language would probably increase such differences.

In the final analysis, it seems that all income tax provisions, including section 105(d), go through evolutionary stages of development with each stage closer approaching the ultimate goal of tax legislation, to collect the greatest amount of tax with the least effort and at the same time treat each taxpayer equitably. The first step in this process is to enact a general revenue measure. Secondly, Congress realizes a need to grant relief to some class of taxpayers and deliberately opens a loophole. Thirdly, Congress may discover that its deliberately created loophole has become such for too many others not deserving tax relief. The attempt is then to contract the loopholes so as to eliminate the relief for the undeserving taxpayer. It is belaboring the obvious to state that no tax system can be completely perfected. The most we can hope for is that our tax structure will continue apace toward that invisible, unattainable, and subjective goal denoted "equity."

VII. Conclusion

The present law does not establish any specific requirements which a plan must meet in order for payments to be excludable from the employee's gross income. A plan can be funded or nonfunded and can be insured or noninsured. A plan can be in the form of an enforceable written agreement or merely a company policy; but if the plan is of the latter type, the employee must have been notified formally or informally of its existence prior to receipt of benefits. The exclusion is applicable only to payments attributable to a period of absence from work due to a personal injury or sickness. The use of the word "plan" implies something more than *ad hoc* benefits.

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